DEPARTMENT OF STATE REVENUE

04-20100691.LOF

Letter of Findings: 04-20100691
Gross Retail Tax
For the Years 2007, 2008, and 2009

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ISSUES

I. Exemption Certificates – Gross Retail Tax.

Authority: IC § 6-2.5-8-8(a); IC § 6-8.1-5-1(c).

Taxpayer argues that the Department is required to review newly submitted exemption certificates and to adjust the original proposed assessment of sales/use tax.

II. Direct Production – Gross Retail Tax.

Authority: IC § 6-8.1-5-1(c); Mynsberge v. Dep't of State Revenue, 716 N.E.2d 629 (Ind. Tax Ct. 1999); Tri-States Double Cola Bottling Co. v. Dep't of State Revenue, 706 N.E.2d 282 (Ind. Tax Ct. 1999); Indiana Dept. of State Revenue v. Kimball Int'l Inc., 520 N.E.2d 454 (Ind. Ct. App. 1988); 45 IAC 2.2-5-8; 45 IAC 2.2-5-8(b); 45 IAC 2.2-5-8(c); 45 IAC 2.2-5-8(g).

Taxpayer maintains that it was not required to collect tax on the sale of its fire suppression equipment because the equipment is directly involved in the direct production of its customers' food products.

III. Safety Equipment – Gross Retail Tax.

Authority: IC § 6-2.5-5-3(b); 45 IAC 2.2-5-8(c)(2)(F); 45 IAC 2.2-5-8(c); 45 IAC 2.2-5-8(c)(4).

Taxpayer states that it was not required to collect tax on the sale of its fire suppression equipment because the equipment is necessary for its customers' employees to safely engage in the preparation of the customers' food products.

IV. Apportionment – Gross Retail Tax.

Authority: IC § 6-2.5-5-1(a); 45 IAC 2.2-1-1(a).

Taxpayer argues that it was not required to collect sales tax on the entire cost of fire suppression equipment because 40 percent of the cost of equipment is attributable to labor.

V. Delivery Charges – Gross Retail Tax.

Authority: IC § 6-2.5-1-5(a); IC § 6-2.5-2-1(a); IC § 6-2.5-2-1(b); 45 IAC 2.2-1-1(a).

Taxpayer maintains it was not required to collect sales tax on charges attributable to "delivery" costs because the customer charges are actually attributable to labor expenses.

VI. Service Agreements – Gross Retail Tax.

Authority: Sales Tax Information Bulletin 2 (December 2006); Sales Tax Information Bulletin 2 (May 2002); Letter of Findings 04-20050438 (August 11, 2006).

Taxpayer states it was not required to collect tax on the sale of warranty/service agreements because the agreements do not provide for Taxpayer to ever provide tangible personal property.

STATEMENT OF FACTS

Taxpayer is an Indiana company which sells fire suppression equipment. Taxpayer has business locations both inside Indiana and outside Indiana. The Department of Revenue (Department) conducted an audit review of Taxpayer's business records and concluded that Taxpayer owed additional sales/use tax. Taxpayer disagreed with a portion of the assessment and submitted a protest to that effect. An administrative hearing was conducted. This Letter of Findings results.

I. Exemption Certificates – Gross Retail Tax.

DISCUSSION

Under certain circumstances, a retail merchant – such as Taxpayer – is not required to collect sales tax. For example, under IC § 6-2.5-8-8(a), "A person... who makes a purchase in a transaction which is exempt from the state gross retail tax and use taxes, may issue an exemption certificate to the seller instead of paying the tax." Once the purchaser provides the exemption certificate, the retail merchant is under no obligation to collect sales tax on the transaction. IC § 6-2.5-8-8(a) states that, "A seller accepting a proper exemption certificate under this section has no duty to collect or remit the state gross retail or use tax on that purchase."

Taxpayer has provided exemption certificates which purportedly relieve Taxpayer from responsibility for collecting sales tax on certain transactions for which the audit review otherwise assessed tax.

The assessments contained in the original audit review report are presumed correct. IC § 6-8.1-5-1(c) states that, "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid." Once the assessment has been made, "The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." Id.

Nonetheless, because Taxpayer has belatedly provided exemption certificates relevant to certain of the

challenged assessments, Taxpayer has met its burden of demonstrating that a portion of the original sales tax assessment may be incorrect. Therefore, the audit division is respectfully requested to review the newly submitted exemption certificates and to make whatever adjustments as may be appropriate.

FINDING

Taxpayer's protest is sustained subject to audit verification.

II. Direct Production – Gross Retail Tax.

DISCUSSION

Taxpayer argues that the sale of its fire protection equipment is exempt because the fire protection equipment is directly used in the direct production of tangible personal property. In this particular case, the "tangible personal property" consists of the food prepared by Taxpayer's customers.

Taxpayer asks what it believes is an essential question. "[B]ut for the safety equipment, could the manufacturing process occur? But for the fires suppression equipment installed in the exhaust hoods, could the commercial kitchen accomplish the processing of food?"

The authority for the exemption Taxpayer seeks is found 45 IAC 2.2-5-8. The regulation in part states as follows:

> (a) In general, all purchases of tangible personal property by persons engaged in the direct production, manufacture, fabrication, assembly, or finishing of tangible personal property are taxable. The exemption provided in this regulation [45 IAC 2.2] extends only to manufacturing machinery, tools, and equipment directly used by the purchaser in direct production. It does not apply to material consumed in production or to materials incorporated into tangible personal property produced.
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> (b) The state gross retail tax does not apply to sales of manufacturing machinery, tools, and equipment to be directly used by the purchaser in the direct production, manufacture, fabrication, assembly, or finishing of tangible personal property.
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> (c) The state gross retail tax does not apply to purchases of manufacturing machinery, tools, and equipment to be directly used by the purchaser in the production process provided that such machinery, tools, and equipment are directly used in the production process; i.e., they have an immediate effect on the article being produced. Property has an immediate effect on the article being produced if it is an essential and integral part of an integrated process which produces tangible personal property. (Emphasis added).

As a threshold issue, it is the Taxpayer's responsibility to establish that the existing tax assessment is incorrect. As stated in IC § 6-8.1-5-1(c), "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made."

In applying any tax exemption, the general rule is that "tax exemptions are strictly construed in favor of taxation and against the exemption." Indiana Dept. of State Rev. v. Kimball Int'l Inc., 520 N.E.2d 454, 456 (Ind. Ct. App. 1988).

In particular, 45 IAC 2.2-5-8, like all tax exemption provisions, is strictly construed against exemption from the tax. Tri-States Double Cola Bottling Co. v. Dep't of State Revenue, 706 N.E.2d 282, 283 (Ind. Tax Ct. 1999); Mynsberge v. Dep't of State Revenue, 716 N.E.2d 629, 636 (Ind. Tax Ct. 1999).

The Department is unable to agree that Taxpayer has established that the fire suppression equipment is exempt based on the cited authority. Although the Department agrees with the general premise that certain items of equipment may be exempt because the items are used in the production of food products, Taxpayer's fire suppression equipment does not fall in that category because the equipment is not "directly used by the purchaser in the direct production, manufacture, fabrication, assembly, or finishing of tangible personal property." 45 IAC 2.2-5-8(b). In other words, the fire suppression equipment does not have "an immediate effect on the article being produced." 45 IAC 2.2-5-8(c). Taxpayer's fire suppression is certainly not frivolous, but "[t]he fact that particular property may be considered essential to the conduct of the business or manufacturing because its use is required by either law or by practical necessity does not itself mean that the property 'has an immediate effect upon the article being produced.'" 45 IAC 2.2-5-8(g).

FINDING

Taxpayer's protest is respectfully denied.

III. Safety Equipment – Gross Retail Tax.

DISCUSSION

Taxpayer again poses what it believes is a critical question. But for the fire suppression equipment, "could the commercial kitchen accomplish the processing of food?" Taxpayer states "on a practical level, the processing could not occur since the danger of fires would be too great exposing workers to unacceptable risks."

IC § 6-2.5-5-3(b) exempts from sales tax liability those "[t]ransactions involving manufacturing machinery, tools, and equipment" and states that such transactions "are exempt from the state gross retail tax if the person acquiring that property acquires it for direct use in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of other tangible personal property." (Emphasis added).

The Department has issued regulations interpreting this exemption provision. In this case, the applicable regulation is found at 45 IAC 2.2-5-8(c)(2)(F). Under that regulation property exempt under IC § 6-2.5-5-3(b),

exhibits the requisite "direct use" and is consequently exempt under IC § 6-2.5-5-3(b) if it has "an immediate effect on the article being produced" and is an "essential and integral part of an integrated process which produces tangible personal property." 45 IAC 2.2-5-8(c). Specifically, under 45 IAC 2.2-5-8(c)(2)(F) "[s]afety clothing or equipment which is required to allow a worker to participate in the production process without injury" comes within the definition of equipment which is part of the taxpayer's integrated production process and is, therefore, exempt."

Again, the Department does not believe the fire suppression equipment is unimportant but does question whether the equipment is related to the "direct production" of its customers' food product. Instead, the equipment at issue is analogous to fire protection equipment installed in any other portion of customers' facilities. The Department believes that 45 IAC 2.2-5-8(c)(4) addresses the issue stating as follows:

> Because the lack of an essential and integral relationship with the integrated production system.... the following types of equipment are not exempt.... A fire extinguisher hung on a wall inside the plant.

Although Taxpayer's fire suppression equipment is not "hung on a wall" as described in 45 IAC 2.2-5-8(c)(4), the Department concludes that Taxpayer's equipment is analogous to the cited example and is not exempt under IC § 6-2.5-5-3(b).

FINDING

Taxpayer's protest is respectfully denied.

IV. Apportionment – Gross Retail Tax.

DISCUSSION

When Taxpayer installs its fire suppression equipment, it presents its customers with a bill. Taxpayer collects sales tax on a portion of the amount charged to those customers. Taxpayer explains that "historically, it has generated data based on its experience in providing such services; sixty percent (60[percent]) of the total cost for such a job entails the tangible personal property provided (such as pipes, nozzles, chemical tanks and cables) while forty percent (40[percent] represents the labor involved in the installation process." As a result of this calculation, Taxpayer submits a single bill to its customers and charges sales tax on sixty percent of the total cost listed on the bill. In addition, Taxpayer asserts that, "The DOR has audited Taxpayer numerous times in the past and accepted this allocation as valid."

As a threshold, the Department must take issue with Taxpayer's contention that the Department has agreed with Taxpayer's apportionment of its labor and material costs. There is no documentary evidence that Taxpayer's 60/40 methodology has been reviewed by the Department in the past or that the Department has ever agreed with Taxpayer's 60/40 apportionment methodology. Instead, the Department concludes that these charges constitute the "unitary transactions" contemplated by the relevant statute and Departmental regulations.

IC § 6-2.5-1-1(a) states:

> Except as provided in subsection (b), "unitary transaction" includes all items of personal property and services which are furnished under a single order or agreement and for which a total combined charge or price is calculated.

45 IAC 2.2-1-1(a) states:

> For purposes of the state gross retail tax and use tax, such taxes shall apply and be computed in respect to each retail unitary transaction. A unitary transaction shall include all items of property and/or services for which a total combined charge or selling price is computed for payment irrespective of the fact that services which would not otherwise be taxable are included in the charge or selling price. (Emphasis added).

Therefore, when a retail merchant combines its charges for services and its charges for tangible personal property into one price which it then bills its customer, the sale of the goods and services constitutes a unitary transaction and the retail merchant is responsible for collecting sales tax on the entire combined price it charges those customers. As provided by IC § 6-2.5-5-1(a) and 45 IAC 2.2-1-1(a), when a single amount is charged for materials and for services, the single amount charged is a unitary transaction and sales tax applies to the total amount charged. Therefore, since the invoices at issue are for unitary transactions and since sales tax is imposed on the total amount charged under a unitary transaction, the Department properly imposed sales tax on the total amount charged on the invoices.

FINDING

Taxpayer's protest is respectfully denied.

V. Delivery Charges – Gross Retail Tax.

DISCUSSION

In reviewing Taxpayer's customer invoices, the audit found "that sales tax was not charged and use tax was not accrued on freight charges." The audit assessed sales/use tax on these charges.

Taxpayer disagrees as follows:

> The trucking and shipping charges which the audit[] proposes to tax are a misnomer. The substance of such charges are payments for additional labor costs incurred by Taxpayer in providing additional services. In certain instances, Taxpayer must require its driver to work additional time and travel additional distances to make deliveries; Taxpayer must compensate these employees for their time and Taxpayer passes these costs on to the customer. While Taxpayer may have poorly labeled these costs, the substance can be clearly

established and, as such, should be exempt.

Indiana imposes an excise tax called "the state gross retail tax" ("sales tax") on retail transactions made in Indiana. IC § 6-2.5-2-1(a). A retail merchant – such as Taxpayer – collects the tax as an agent for the state. IC § 6-2.5-2-1(b).

IC § 6-2.5-1-5(a) defines "gross retail income" subject to the state gross retail tax as follows:

> Except as provided in subsection (b), "gross retail income" means the total amount of consideration, including cash, credit, property, and services, for which tangible personal property is sold, leased, or rented, valued in money, whether received in money or otherwise, without any deduction for:
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> (1) the seller's cost of the property sold;
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> (2) the cost of materials used, labor or service cost, interest, losses, all costs of transportation to the seller, all taxes imposed on the seller, and any other expense of the seller;
>
> (3) charges by the seller for any services necessary to complete the sale, other than delivery and installation charges;
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> (4) delivery charges[.] (Emphasis added).

Clearly, Indiana law imposes sales tax on delivery charges and the audit correctly concluded that Taxpayer should have collected sales tax on those charges. Nonetheless, Taxpayer maintains that its "delivery charges" actually cover the cost of installing its fire suppression equipment and expenses attributable to having its "driver... work additional time and travel additional distances to make deliveries." However, the Department must conclude that these expenses are no more and no less than what the term implies. Whether the additional expenses related to paying its employees, the time spent on installing the fire suppression equipment, or the costs related to fuel expenses, "delivery charges" are subject to sales tax and the Taxpayer should have collected sales tax on these charges. Even if Taxpayer were to parse its delivery charges, the costs charged Taxpayer's customers – including the "delivery charges" which appear on its customers' invoices – constitute "unitary transactions" as discussed in Part IV above. As a single cost charged for "for materials and for services," Taxpayer was required to collect sales tax on that single cost "irrespective of the fact that services which would not otherwise be taxable are included in the charge or selling price." 45 IAC 2.2-1-1(a).

FINDING

Taxpayer's protest is respectfully denied.

VI. Service Agreements – Gross Retail Tax.

DISCUSSION

Taxpayer disagrees with the assessment of sales/use tax on the sale of service agreements to its customers. Insofar as the service agreements that Taxpayer sells its customers, the audit found as follows:

> Sales tax was partially charged on these items. The [T]axpayer informed the auditor that they were taxing 60[percent] of these charges to account for the materials used. Following Information Bulletin []2, optional extended warranties or maintenance agreements [that] provide assurances that any required service and parts will be provided in the event of a break down or malfunction of the covered part. Some of these agreements also contain provision for periodic inspection or preventative maintenance activities where tangible personal property will be supplied as a part of the unitary price. Optional warranties and maintenance agreements that contain the right to have property supplied in the event it is needed are subject to sales tax if there is a reasonable expectation that tangible personal property will be provided.

At the outset, it should be noted that Taxpayer has not protested – and this Letter of Findings does not address – the taxes assessed on Taxpayer's purchase of software maintenance agreements. The Department's stance on this issue is set out in Letter of Findings 04-20050438 (August 11, 2006), 20061101 Ind. Reg. 045060474NRA, and need not be repeated here.

It should also be noted that the Department finds no support for Taxpayer's position that, in instances in which Taxpayer's customer is purchasing services and tangible personal property, Taxpayer will simply bill the customer sales tax on a "flat" 60 percent of the total cost. As noted above in Part IV, a combined bill for services and tangible personal property is a "unitary transaction" and sales tax is correctly charged on the entire cost.

The prior version of Sales Tax Information Bulletin 2 stated as follows:

> Optional warranties and maintenance agreements that contain the right to have property supplied in the event it is needed are not subject to sales tax. Any parts or tangible personal property supplied pursuant to this type of agreement are subject to use tax. Sales Tax Information Bulletin 2 (May 2002) 25 Ind. Reg. 3595 (Emphasis added).

However, the current version of Sales Tax Information Bulletin 2 states as follows:

> Optional warranties and maintenance agreements that contain the right to have property supplied in the event it is needed are subject to sales tax if there is a reasonable expectation that tangible personal property will be provided. Any parts or tangible personal property supplied pursuant to this type of agreement are not subject to sales or use tax. Sales Tax Information Bulletin 2 (December 2006) (20100804 Ind. Reg. 045100497NRA)(Effective August, 4, 2010) (Emphasis added).

The Department's guidance and interpretation on this issue relevant to the years for which Taxpayer was audited is found in Sales Tax Information Bulletin 2 (May 2002) which states that "Optional warranties and

maintenance agreements that contain the right to have property supplied in the event it is needed are not subject to sales tax." Id. Therefore, Taxpayer was not required to collect sales tax on the warranties/maintenance agreements it sold its customers prior to August 4, 2010. However, it should be noted that during this same period, Taxpayer was required to self-assess use tax on any of the parts or supplies it provided its customers pursuant to those same agreements.

Taxpayer is on notice that as of August, 4, 2010, Taxpayer is required to collect sales tax on the warranties/maintenance agreements it sells to its customers. The corollary remains true; under this regime, Taxpayer is not required to self-assess use tax on parts and supplies furnished pursuant to those later agreements.

The audit division is requested to review the original assessment of tax on the sale of warranties/maintenance agreements to its customers based on Sales Tax Information Bulletin 2 (May 2002) in effect during the audited years and to make whatever adjustment is appropriate.

FINDING

Subject to audit review, Taxpayer's protest is sustained.

SUMMARY

The Department's audit division is requested to review the newly submitted exemption certificates and to make whatever adjustments are warranted. Similarly, the audit division is requested to review Taxpayer's maintenance agreements and to verify that the assessment comports with the Part VI above. In all other respects, Taxpayer's protest is denied.

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